

Research Department
Federal Reserve
Bank of
San Francisco

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Gradualism

The recession appears finally to have arrived, considering the fact that the number of unemployed workers and the amount of unused manufacturing capacity have now reached the highest levels of the past two to three years. As further evidence, the index of leading business-cycle indicators dropped sharply in March, climaxing a year-long downtrend.

Will a recession cure the longstanding problem of inflation? If so, how long and how deep a recession will be needed to do the job? Or can the problem be solved through the gradual application of fiscal and monetary discipline, with emphasis on a slow but steady reduction in money-supply growth?

Gradualism has long been advocated by many economists, such as the members of the Shadow Open Market Committee (SOMC), a group of monetarist-minded private economists who have been monitoring the Federal Reserve's performance since 1973. According to their view, a reduction in the money-growth rate of one percentage point a year could cut the inflation rate to 3 percent by 1985. Moreover, they argue that that result could be achieved with only a mild recession, which would cure itself as the market became convinced that the policy of decelerated growth would continue.

Other economists disagree, arguing that prices are less responsive to changes in economic conditions and policy actions than the SOMC suggests. Harvard economist Otto Eckstein, for example, claims that the inflation rate could be reduced to 6 percent by 1985, but only after a prolonged period of recession involving a 10-percent average unemployment rate.

Natural rate

To put these different viewpoints into perspective, we should analyze the concept of the "natural rate of unemployment"—the

full-employment rate which, if maintained, would be consistent with a stable inflation rate. The inflation rate will rise as long as the unemployment rate remains below the natural rate—even if the jobless rate is rising at the same time. On the other hand, the inflation rate will fall as long as the unemployment rate remains above the natural rate. The natural rate probably has increased over the past several decades, under the impact of demographic and institutional changes. According to most estimates, the rate ranged between 4.0 and 4.7 percent in the mid-1950's, but rose to between 5.0 and 6.0 percent in the mid-1970's, and even further to about 6.5 percent in the late 1970's.

An alternative measure is the "natural rate of capacity utilization," since the link between inflation and labor-force utilization can be translated into a link between inflation and manufacturing-capacity utilization. This link is understandable, because the natural rate of unemployment implies a stable equilibrium rate of growth in final output, which in turn implies an equilibrium rate of capacity utilization. But this rate, unlike the natural rate of unemployment, has remained relatively stable in recent decades. Since the early 1950's, the inflation rate generally declined when capacity utilization rates fell below 82 percent of capacity, and increased when capacity utilization rose above that figure.

The relationship between inflation and capacity utilization may be portrayed graphically, with a counterclockwise movement evident in the line linking the annual points of intersection (see chart). In the mid-1950's, for example, inflation increased when utilization rates rose above their equilibrium natural rate—and continued rising as long as utilization rates remained high, even in the 1956-57 period of decelerating output growth. However, the inflation rate decelerated during the

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steep 1958 recession, reflecting a decline in capacity utilization, so that the long expansion of the 1960's began with a relatively low inflation rate. In contrast, the expansion a decade later began with a high inflation rate, reflecting the strains on industrial capacity during the 1960's as well as the mildness of the ensuing recession.

The same type of counterclockwise movement can be seen in the expansion of the late 1970's. In 1978-79, for example, the business expansion pushed the economy above stable-inflation utilization rates, with the unemployment rate averaging less than 6 percent and the capacity-utilization rate reaching 85 percent. Consequently, the imbedded rate of inflation accelerated, quite apart from the shocks administered by oil and farm price increases.

How much relief?

Given this background, how much inflation relief can we expect in the weaker business environment of the early 1980's? The historical record would suggest support for the Eckstein thesis, since the inflation rate appears to decline slowly in response to changes in capacity utilization or unemployment. For instance, inflation on average declines one percentage point for each year that unemployment remains three percentage points above its natural rate, or for each year that capacity utilization remains eight percentage points below its natural rate of 82 percent. Thus the consumer price index, on an annual-average basis, could decline from about 11½ percent in 1979 to about 6 percent in 1985—but only if we experience 10-percent unemployment over the intervening period.

What grounds are there for such a pessimistic conclusion? According to the standard line of reasoning, a business downturn today leads to relatively small wage reductions in future labor contracts, since both labor and management expect government to stimulate economic activity whenever there are signs of rising unemployment and falling industrial

activity. People come to expect strong countercyclical government actions—and expect everyone else to anticipate the same—so that there is little incentive for labor to accept lower wages or for firms to lower prices. Under such circumstances, a prolonged recession seems required to generate any relief from inflation.

Other observers, such as the members of the Shadow Open Market Committee, argue that this result is not foreordained. The pessimistic conclusion depends on the public's belief that government policies will be the same in the future as in the past. But the results would be different if government policies change—and if the public decides that the new policies will remain in effect.

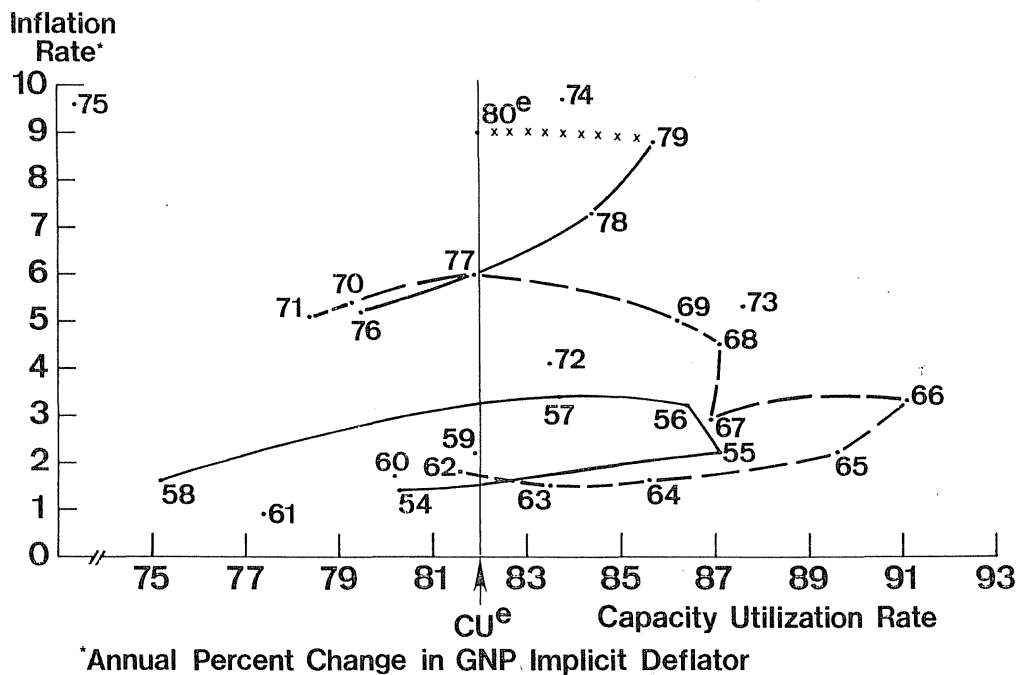
Policy . . . and outside shocks

In the present context, the reaction to the strong policies adopted in the past six months should help determine the inflation outlook for the period ahead. If labor, management and consumers believe in policymakers' determination to overcome inflation, they will adjust their behavior patterns accordingly, so that we could experience greater price and wage flexibility than in the past. The SOMC's inflation forecast, though contrary to recent historical experience, thus has good prospects of success.

Outside shocks will continue to affect the price outlook. Import fees on crude oil and gasoline could mean a rise of 0.75 percentage points in the inflation rate, and higher OPEC price quotations could boost the index even more. Still, a recession and sluggish recovery should mean less pressure on labor and capital markets and thus reduced price pressure from that source. But if we are to make substantial progress in the fight against inflation, policymakers will have to adhere to the present gradualist policy, and the public will have to perceive this policy as continuing.

Rose McElhattan

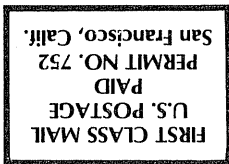
Inflation Rate and Capacity Utilization Rate



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding	Change from	Change from	
			Year	Percent
Large Commercial Banks	4/23/80	4/16/80	Dollar	Percent
Loans (gross, adjusted) and investments*	138,355	- 368	+ 13,397	+ 10.7
Loans (gross, adjusted) — total#	116,563	- 350	+ 14,710	+ 14.4
Commercial and industrial	33,697	- 167	+ 3,230	+ 10.6
Real estate	45,963	+ 117	+ 9,117	+ 24.7
Loans to individuals	24,419	- 13	+ 2,829	+ 13.1
Securities loans	1,001	- 37	- 398	- 28.4
U.S. Treasury securities*	6,541	+ 7	- 1,413	- 17.8
Other securities*	15,251	- 25	+ 100	+ 0.7
Demand deposits — total#	43,251	-3,111	+ 527	+ 1.2
Demand deposits — adjusted	32,226	- 719	+ 686	+ 2.2
Savings deposits — total	26,222	- 377	- 3,551	- 11.9
Time deposits — total#	63,929	+ 674	+ 14,051	+ 28.2
Individuals, part. & corp.	55,069	+ 539	+ 14,582	+ 36.0
(Large negotiable CD's)	22,784	+ 285	+ 5,617	+ 32.7
Weekly Averages of Daily Figures	Week ended 4/23/80	Week ended 4/16/80	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	479	35		66
Borrowings	148	31		122
Net free reserves (+)/Net borrowed(-)	331	4		- 55

* Excludes trading account securities.

Includes items not shown separately.

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